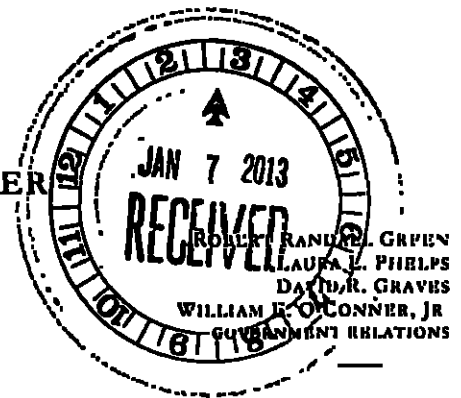


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ERIC VON SALZPN
OF COUNSEL

January 7, 2013

Ms. Cynthia T. Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, SW
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ENTERED
Office of Proceedings

JAN 07 2013

Part of
Public Record

Re. STB EP Docket No. 715
Rate Regulation Reforms

Dear Ms. Brown,

Enclosed for in the above-referenced proceeding, please find an original and twenty (20) copies of the Rebuttal Argument of Arkansas Electric Cooperative Corporation together with one (1) electronic disc containing an electronic version of the filing

Finally, I have enclosed an additional two copies of the above noted filing to be date-stamped and returned to the bearer of this letter.

Respectfully submitted

Mary Thekla Sell

Enclosures
cc: Parties of Record

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

DOCKET NO. EP 715

RATE REGULATION REFORMS

**REBUTTAL COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION**



**ENTERED
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JAN 07 2013

**Part of
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**Counsel for Arkansas Electric Cooperative
Corporation**

Dated: January 7, 2013

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

DOCKET NO. EP 715

RATE REGULATION REFORMS

**REBUTTAL COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION**

In accordance with the Board's Decision served July 25, 2012, Arkansas Electric Cooperative Corporation (AECC) submits these rebuttal comments in response to reply comments of BNSF Railway ("BNSF"), Union Pacific Railroad ("UP"), and the Association of American Railroads (AAR) regarding issues raised by AECC in its opening filing.

DISCUSSION

AECC's opening comments focused primarily on three of the changes proposed by the Board: (1) removing the simplified computation of road property investment (RPI) currently used in Simplified-SAC; (2) restricting the use of cross-over traffic in Full-SAC cases; and, (3) modifying the approach used to allocate revenue from cross-over traffic in Full-SAC and Simplified-SAC cases

Calculation Of Road Property Investment In Simplified-SAC Cases.

Regarding the simplified computation of RPI currently used in Simplified-SAC, AECC presented and described a specific proposal that the simplified RPI computation be

retained as a rebuttable presumption to ensure that important benefits of Simplified-SAC – for both railroads and shippers - are preserved. See Opening Comments Of Arkansas Electric Cooperative Corporation (AECC Opening), at 3-5. As AECC explained, there is no evidence that the proposed change suggested by the Board is necessary in every case to assure that the Simplified-SAC is reasonably accurate; thus, it would place “a substantial burden on the parties to rectify a problem that may not exist.” Id. at 3. Therefore, AECC proposed:

Rather than require a Full-SAC calculation of RPI in every Simplified-SAC case, AECC recommends that the Board establish a presumption that the current Simplified-SAC method may be used, but allow either party to present evidence to rebut that presumption by showing that the Full-SAC method for calculating RPI yields a significantly different result in that case.

Id. In their replies, the railroads parties offered no criticisms of this proposal, which stands unopposed, and should be adopted by the Board for the reasons given in AECC opening comments.

The railroad replies did comment extensively on issues related to cross-over traffic, and it is to those issues that we turn next.

Cross-Over Traffic

In its opening comments, AECC showed why the use of cross-over traffic in Full-SAC cases should not be restricted as the Board has proposed (see AECC Opening at 5-6), and presented an alternative approach to the analysis of revenue from cross-over traffic (see AECC Opening at 6-10). Not surprisingly, the reply comments of the railroad parties seek to minimize or eliminate the economic significance of cross-over traffic.

As described further in the attached Rebuttal Verified Statement of Michael A. Nelson, the efforts of the railroad parties to suppress the role of cross-over traffic overlook authoritative and unambiguous guidance regarding cross-over traffic issues that already is in the Board's possession. The railroads' arguments disregard sound economic principles and criteria needed for the proper implementation of Constrained Market Pricing, as endorsed by a consensus of 16 notable economists, many of whom participated in the original development of the theory of CMP. Mr. Nelson shows that the principles and criteria endorsed by these economists support fully AECC's proposals regarding cross-over traffic.

CONCLUSION

AECC urges the Board to modify its proposed treatment of RPI in Simplified-SAC cases to provide a presumption that the current method for calculating RPI may be used, but this presumption may be rebutted by evidence that the Full-SAC method for calculating RPI yields a significantly different result in that case. AECC also urges the Board not to adopt the proposed limits on the types of cross-over traffic that may be considered in Full-SAC and Simplified-SAC cases. AECC further urges the Board not to adopt the modified ATC method for allocating cross-over traffic revenue; rather, the Board should use an incremental-type analysis as AECC has described that is consistent with the principles of Constrained Market Pricing and the real world behavior of railroads and of the highly competitive markets for investment funds.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'Eric Von Salzen', is written over a horizontal line.

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Transportation Consultant

Dated: January 7, 2013

**REBUTTAL VERIFIED STATEMENT
OF
MICHAEL A. NELSON**

**REBUTTAL VERIFIED STATEMENT
OF
MICHAEL A. NELSON**

I. Qualifications

My name is Michael A. Nelson. I am an independent transportation systems analyst with 32 years of experience in railroad competition and coal transportation. My office is in Dalton, Massachusetts.

I have directed or participated in numerous consulting assignments and research projects in the general field of transportation. My work typically involves developing and applying methodologies based on operations research, microeconomics, statistics and/or econometrics to solve specialized analytical problems.

Over the past 28 years I have provided testimony before this Board and its predecessor regarding numerous railroad issues. Of particular relevance to this statement, I provided testimony in Docket Nos. EP 657 (Rail Rate Challenges Under the Stand Alone Cost Methodology); FD 35506 (Western Coal Traffic League – Petition For a Declaratory Order); and EP 657 (Sub-No. 1) (Major Issues in Rail Rate Cases), which included the original introduction of AECC's proposed method for analyzing revenue from cross-over traffic. I also assisted in the preparation of AECC's comments in Docket Nos. EP 664 (Methodology to be Employed in Determining the Railroad Industry's Cost of Capital); EP 664 (Sub-No. 1) (Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital); EP 558 (Sub-No. 12) (Railroad Cost of Capital – 2008); and EP 671 (Rail Capacity and Infrastructure Requirements).

I received my bachelor's degree from the Massachusetts Institute of Technology in 1977. In 1978, I received two master's degrees from MIT, one in Civil Engineering (Transportation Systems) and one from the Alfred P. Sloan School of Management, with concentrations in economics, operations research, transportation systems analysis and public sector management. Prior to February 1984 I was a Senior Research Associate at Charles River Associates, an economic consulting firm.

2. Cross-over Traffic Issues

I have been asked by AECC to investigate and respond to the reply comments of BNSF Railway ("BNSF"), Union Pacific Railroad ("UP"), and the Association of American Railroads (AAR) regarding cross-over traffic issues raised by AECC in its opening filing.

There is no doubt that cross-over traffic in SAC analyses has presented some vexing implementation problems. This is evident in, for example, UP's listing of 10 different revenue allocation processes that have been proposed or used by the Board.¹ While many of the railroad reply comments pertain to specific cross-over traffic restrictions or revenue allocation proposals, collectively they overlook authoritative and unambiguous guidance regarding cross-over traffic issues that already is in the Board's possession.

For example, BNSF attempts to bundle together shipper suggestions regarding specific reforms as "result-oriented" and lacking "economic justification", and refers the Board to Constrained Market Pricing (CMP) principles as if such principles refute shipper suggestions.² Likewise, UP simply asserts, without substantiation, that AECC's proposed treatment of revenue

¹ Reply Comments of Union Pacific Railroad Company (hereafter, "UP Reply") at 6, fn5.

² BNSF Railway Company's Reply Comments ("BNSF Reply") at 2-3.

from cross-over traffic "makes no sense"³ However, the ICC's plan for implementing CMP - as announced in February 1983 - was endorsed by a consensus of 16 notable economists, many of whom participated in the development of the theory of CMP. The verified statement signed by the economists⁴ (hereafter, "VS Economists") reveals that CMP principles support AECC's proposals regarding cross-over traffic and do not support the restrictive view of such traffic expressed in the railroad replies (or, for that matter, in the Board's proposed methodology changes)

VS Economists describes plainly the balance of objectives that is to be achieved under CMP. On the one hand, the carrier needs to achieve revenues that cover all costs, including a competitive rate of return on the facilities it uses.⁵ On the other hand, the revenues achieved by the carrier must not exceed the level that would prevail under "effective active or potential competition".⁶ Both the ICC proposal and VS Economists recognize that such a limitation on revenues is an essential check against cross-subsidy, which otherwise "may result in a misallocation of resources by encouraging inefficient investment."⁷ The proper balance is only achieved when a rail investment, such as the investment in the facilities used by the issue traffic, earns no more and no less than a competitive market rate of return.

³ UP Reply at 12

⁴ See ICC Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines – Nationwide, "Verified Statement of Economists Supporting the Principles of Constrained Market Pricing" (June 1983). A copy of this document is accessible in STB Docket No. EP 657 (Sub-No. 1), Major Issues in Rail Rate Cases, "Comments of BNSF Railway Company" (May 1, 2006), VS Willig, Exhibit RDW-2.

⁵ VS Economists at 3.

⁶ VS Economists at 6-7

⁷ VS Economists at 7-8.

VS Economists and the ICC proposal to which it responds agree explicitly that rates “...in excess of the minimum current cost of providing any group of services” [emphasis added] represent an abuse of market power that CMP is supposed to avoid.⁸ In any analysis of the investment worthiness of the facilities used by the issue traffic, the “group of services” represented by all traffic that uses those facilities is intrinsically relevant. Any systematic exclusion from the analysis of revenue from any portion of that “group” would simply enable such revenue to accrue to the carrier above and beyond the “minimum current cost” standard applied to the traffic included in the analysis. Put another way, the restrictions on cross-over traffic favored by the rail parties would produce precisely the type of market power abuse that the SAC test is supposed to prevent.

VS Economists and the ICC proposal to which it responds also agree that the investment in the facilities used by the issue traffic must be viewed not from the perspective of a rail carrier wielding market power, but rather from the competitive standard established by the hypothetical threat of “(e)ntry into the market by a firm willing to charge no more than is necessary just to cover that level of costs.”⁹ Investment in the facilities used by the issue traffic tends to create opportunities to earn contribution from non-issue traffic that would use the same facilities. A “firm willing to charge no more than is necessary just to cover” the costs associated with constructing and operating the facilities used by the issue traffic would take into account not only all of the contribution produced by the issue traffic, but also all of the contribution from other traffic movements that would become viable as a result of that construction. Most obviously, this

⁸ VS Economists at 7.

⁹ VS Economists at 6

includes non-issue traffic that originates and/or terminates on the facilities used by the issue traffic. It also includes non-issue “bridge” traffic that traverses those facilities on routes that would not exist absent the construction of those facilities.¹⁰

Importantly, this is not just the outcome of a theoretical exercise conjured up by a hunch of academics. It also reflects the way a railroad in the real world would analyze a potential investment in the facilities used by the issue traffic so that such an investment could compete properly in the highly competitive market for investment funds. If investment in a given set of facilities would enable the railroad to handle traffic that generates a given amount of incremental contribution, the proportions of such traffic movements that actually occur on the subject facilities are completely irrelevant to the railroad and investors alike. For example, when the railroads evaluated the facility investments needed to establish rail access to the Powder River Basin, it was the incremental contribution associated with the incremental traffic stemming from such investments that was the relevant consideration. They did not consider some artificial allocation that would ascribe little contribution to the Joint Line (and, for UP/CNW/WRPI, the Connector Line) based on the comparatively small proportion of the length of typical PRB movements associated with the constructed facilities. In the real world, it is this type of incremental analysis – not cost allocation – that forms the heart of the competitive market for

¹⁰ In some very limited circumstances it arguably might be possible for such bridge traffic to move (without incurring excessive circuitry) via routes that do not involve the facilities used by the issue traffic. In such circumstances, the portion of the contribution from the bridge traffic that would be relevant to assessment of investment in the facilities used by the issue traffic would be the reduction in variable costs of the bridge traffic movements resulting from the construction of the facilities used by the issue traffic. Given that railroads have had over 30 years to rationalize their networks through mergers, abandonments, line sales, etc., it is reasonable to presume that redundant parallel routes of equal competitive effectiveness for specific movements within a given carrier's network generally are not available. The Board could allow this presumption to be rebutted in specific situations with a showing of persuasive evidence to the contrary.

investment resources. AECC's proposed treatment of revenue from cross-over traffic is the only method before the Board that reflects this type of incremental analysis.¹¹

VS Economists and the ICC proposal to which it responds further agree that shippers of issue traffic "will not be required to contribute toward the cost of facilities that do not serve them."¹² This confirms that the full contribution from incremental traffic moving on the facilities used by the issue traffic should be retained in the analysis of the issue traffic. The shipper of issue traffic is entitled to an accurate evaluation of the economics associated with the facilities it uses, and is not to be disadvantaged by an allocation of the contribution from incremental traffic carried by those facilities to benefit other parts of a carrier's network, which in this context would form a blatant cross-subsidy of the type VS Economists and the ICC agreed is forbidden. Even if the defendant carrier is revenue inadequate overall, the Board in a SAC analysis cannot legitimately rely on cross-subsidy to rectify any viability issues associated with a carrier's facilities that are not used by issue traffic.¹³

In short, no categories of non-issue traffic would be ignored either by the defendant railroad or by a hypothetical competitive investor in the facilities used by the issue traffic. Likewise, there is no allocation formula that such parties would use - or that would even be permissible to use - to reduce the economic value (i.e., full contribution) of non-issue traffic that

¹¹ UP references the fact that AECC's proposed treatment of revenue from cross-over traffic was not accepted by the Board when it was first advanced in 2006 (UP Reply at 12). However, the Board later concluded that the method it did then select, along with other allocation-type methods it subsequently considered, were not viable. Allocation-type methods having proved unsatisfactory, it would be reasonable for the Board now to consider an incremental-type approach. Given that AECC's proposal is the only incremental-type method put before the Board, UP offers no substantive reason for the Board not to now consider it.

¹² VS Economists at 7-8

¹³ In a similar context, the Board's rules provide that a carrier's "revenue inadequacy" is not a basis for denying a remedy for its anticompetitive conduct. See 49 CFR Section 1144.2(b)(3).

:

can be served as a result of the investment in the facilities used by the issue traffic. These considerations affirm AECC's original conclusion that the use of cross-over traffic in Full-SAC cases should not be restricted, and also demonstrate the rigor and legitimacy of AECC's proposal that the full contribution made by cross-over traffic be used in the analysis.

In my opinion, following the conceptual guidance on CMP principles provided in VS Economists and the ICC's original plan makes far more "sense"¹⁴ than continuing to expand the list of failed allocation-based approaches. AECC's proposed treatment of cross-over traffic provides a conceptually sound and computationally simple method for doing so. The restrictions on cross-over traffic promoted in the railroad party replies, as well as in the Board's original proposed methodology changes, are inconsistent with CMP principles and should be rejected on that basis.

¹⁴ See UP Reply at 12 ("AECC's proposal makes no more sense today than when it was suggested in 2006.").

VERIFICATION

I, Michael A Nelson, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this document.


A handwritten signature in black ink, appearing to read "Michael A. Nelson", written over a horizontal line.

Michael A Nelson

Executed on February 7, 2013

CERTIFICATE OF SERVICE

I hereby certify that on this 7th day of January, 2013, I caused a copy of the foregoing document to be served by first class mail on all parties of record on the service list in this docket.



Eric Von Salzen